Staff Paper

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Project: **Financial Instruments (Replacement of IAS 39)—Hedge Accounting**

Topic: **Hedge accounting—Transition**

Introduction

Purpose

1. This paper addresses the feedback received on the proposals in the exposure draft 2010/13 *Hedge Accounting* (the 'ED') regarding the transition to the new general hedge accounting model.
2. The paper contains seven questions to the Board.
3. This paper does not address the effective date of the new hedge accounting requirements, or the transition to the project to replace IAS 39 – *Financial Instruments Recognition and Measurement* (ie IFRS 9 *Financial Instruments*) as a whole. These issues have been addressed in conjunction with the rest of the project to replace IAS 39. The Board has exposed for comment its tentative decision, on the basis of current circumstances, to propose a mandatory effective date of reporting periods beginning on or after 1 January 2015 for all phases of the project to replace IAS 39.
4. This paper assumes that the hedge accounting requirements can only be applied if all existing IFRS 9 requirements are adopted at the same time or have already been adopted.[1]

1 Refer to paragraph 53 of the ED.

Summary of the feedback received from comment letters and outreach

Prospective application

5. Almost all of the respondents to the ED and participants in the outreach agreed with prospective application of the new hedge accounting requirements, because prospective application will avoid the administrative burden of running two models in parallel and will mitigate the risk of hindsight arising from retrospective application. Supporters also noted that prospective application is consistent with the hedge accounting transition requirements in IAS 39. Some of the supporters of prospective application requested additional guidance in applying the transition provisions to hedging relationships that differ between IAS 39 and the new model, and on the interaction between different phases of the project to replace IAS 39.

Requests for one-off transitional provisions

6. Some of the respondents who agreed with the proposals, and most of the respondents who conditionally agreed, asked the Board to consider a general provision whereby IAS 39 hedging relationships would be automatically grandfathered by the new model until they are discontinued or otherwise rebalanced. These respondents are of the view that changing the hedge accounting model should not force entities to discontinue the hedging relationships that complied with IAS 39 but that do not comply with the new model. These respondents requested that these hedging relationships should continue to be accepted under the new model but could be discontinued and restarted in subsequent periods if they no longer meet the entity's risk management objective. The staff note that this equates to voluntary discontinuation and restart which the Board has tentatively decided is not allowed under the new model.
7. Some respondents who conditionally agreed also asked the Board to consider some one-off transitional provisions at the date of initial application, to accommodate some of the differences between the current and the new model. They requested opportunities to:
   (a) discontinue the IAS 39 hedging relationships that do not comply with the new model and restart new hedging relationships that meet the qualifying criteria of the new model as at the date of initial application ('discontinuation and restart'), on a prospective basis under two possible circumstances: (i) in accordance with the discontinuation provisions (which would result in artificial ineffectiveness for the rest of the hedging relationship), or (ii) with

the non-zero fair value of the hedging instrument as of the discontinuation and restart to be recognised in retained earnings (or other component of equity, as appropriate). If this latter option were to be allowed, the restarted hedging relationship would be accounted for as though the hedging instrument had a zero fair value at inception;

(b) apply the new hedging model retrospectively ('retrospective application'); or

(c) keep the IAS 39 model in place during the comparative period and run the new model in parallel with it, without this affecting the financial statements until after the comparative period has lapsed ('running two models in parallel'). They suggested that hedging relationships could be designated at any time during the comparative period, as long as there was contemporaneous documentation. However, during the transition period from the date of the opening balance sheet to the first financial statements after the mandatory effective date, hedge accounting under IAS 39 would continue to be applied. In their view, this would allow meaningful balances to be presented as comparatives and would accurately reflect the business intentions and risk management strategies employed throughout the period.

8. Some commentators who conditionally agreed requested opportunities at the date of initial application to apply the new model to hedging relationships retrospectively for situations when the eligibility criteria for hedge accounting have been extended—risk components, aggregated exposures, groups and net positions, the time value of options and forward points (ie for hedging relationships that are newly eligible). Some of these requests were made within the context of requesting additional guidance on these issues. They made these requests because, in their view, this would:

(a) allow for consistency in accounting for each hedging relationship over time,

(b) reduce the burden on preparers compared to grandfathering IAS 39 hedging relationships, because they would not have to run both the IAS 39 and the new model at the same time; and

(c) be consistent with the transition requirements for hedge accounting in IFRS 1 –*First time adoption of International Financial Reporting Standards,* if retrospective application extended to the beginning of the first comparative period.

Retrospective application

9. The few respondents who disagreed with the proposals did so because, in their view, application of the new proposals should be fully retrospective to allow entities to better represent the effect of the new hedge accounting model in the financial statements. They consider that the benefits of retrospective application exceed the costs.
10. Some within this group asked the Board to allow elective retrospective application. They consider that transition should be prospective, unless retrospective application is practicable and, in the entity's view, is more representative of the business model and of the objective of the new model—ie more reflective of the entity's risk management activities.
11. In addition, the Board has been asked to consider either requiring or permitting (as an option on a relationship-by-relationship basis) retrospective application if the hedging relationship has been documented within the entity's risk management as an economic hedge, but it did not qualify under the current hedge accounting model.[2]
12. There were also a few respondents who did not agree with the transition and effective date proposals because the Board has not published the proposals on macro hedge accounting. These commentators fundamentally disagree with issuing final requirements on general hedge accounting as part of IFRS 9 until the macro hedge accounting phase is completed.

The issues

ED effective date and transition provisions

13. The transition provisions in paragraphs 53-55 of the ED propose prospective application and an effective date for annual periods beginning on or after 1 January 2013, with earlier application permitted[3]. However, the ED proposes that the new model can be applied only if all existing IFRS 9 requirements were adopted at the same time or had already been adopted. Specifically, for hedge accounting, the Board

[2] Including a request for the Board to consider retrospective application of the fair value risk management strategy in the context of own use contracts.

[3] The staff note that at its 22 July meeting, the Board tentatively decided that the mandatory effective date of IFRS 9 should be changed to annual periods beginning on or after 1 January 2015, and has issued an exposure draft on this proposal with the comment period ending 21 October 2011.

has proposed prospective application for all hedging relationships on the basis of the arguments outlined in paragraphs BC250-254 of the ED:

(a) prospective application would resolve the cost, complexity, and comparability concerns about applying two different hedge accounting models in financial statements and preparing two different sets of disclosures; and

(b) the final standard would allow some one-off transitional provisions to ensure that 'qualifying' hedging relationships are transitioned from the existing model to the new model.

Requests for one-off transitional provisions

14. For the reasons described in the feedback summary above (refer to paragraphs 7 and 8), commentators have made requests for one-off transitional provisions.

Staff recommendations

15. On the basis of the staff analysis in the section below, the staff recommend prospective application in general with limited retrospective application for specific areas. The staff also recommend some one-off transition provisions to supplement the prospective application. These are related to:

    (a) Discontinuation and restart: the staff propose that entities should be allowed to consider the 'same logical second' for the purpose of transitioning into the new model.

    (b) Rebalancing: the staff propose that entities should, for the purpose of rebalancing, be allowed to consider that the starting point for the purpose of applying the new model is the end point of applying the old model.

Staff analysis

Introduction

16. As described in the feedback section above, commentators asked the Board to consider allowing some one-off retrospective application for some of the main differences between the new model and the current model in IAS 39.

17. The ED proposed pure prospective application for all hedging relationships. The staff supported this alternative leading up to the issue of the ED.[4] The Board agreed in general, but it noted in paragraphs BC252 of the Basis for Conclusions to the ED that it intended that the final standard would allow some one-off transitional provisions to allow 'qualifying' hedging relationships to be moved from the existing to the new model.

18. In analysing the requests for one-off transitional provisions, this section considers alternatives for transition in four sections:

    (a) **Section A** discusses retrospective application in general, including the scenarios in which retrospective application can be achieved but it carries the risk of hindsight due to retrospective designation. This section contains two questions to the Board.

    (b) **Section B** addresses retrospective application in circumstances where retrospective designation is not needed but there is some risk of hindsight. This section contains two questions to the Board.

    (c) **Section C** discusses some practical considerations that entities may take into account when transitioning into the new model.

    (d) **Section D** addresses requests for additional guidance.

19. In its analysis, the staff consider that there are three 'levels' of hindsight that could be used in retrospectively applying the new model, depending on the circumstances. They cause varying degrees of concern for the transition to the new hedge accounting model. In order from the greatest concern to the least concern, they are summarised as follows:

    (a) *Hindsight related to retrospective designation:* in order to apply the new model retrospectively, hedging relationships would have to be designated retrospectively from the original inception date (for accounting purposes) of the hedge. This has the potential for causing designation with hindsight, which is discussed further in Section A. This will be the scenario applicable to most of the forms of retrospective application suggested by commentators, including full retrospective application, elective retrospective application and limited retrospective application for the major differences between the new and the current model. These differences apply to risk components, aggregated exposures and groups and net positions.

[4] Refer to Agenda Paper 2 from the 27 October 2010 Board meeting.

(b) *Hindsight related to the application of a particular accounting treatment:* these are the scenarios in which, in order to apply the new hedge accounting model, retrospective designation is not needed (hedge accounting is being applied), but in which in order to apply the revised accounting treatment for the hedging instrument there is the need to perform some Level 3 valuations that carry the risk of hindsight. In contrast to hindsight related to retrospective designation, this represents a different level of hindsight in which the potential for abuse is much smaller. This is because at the transition date, retrospective application would require only a reclassification of amounts in the statement of financial position based on the existing hedge designations at the date of initial application of the hedge accounting model. This will be the case for a limited set of designations: for forward points in the case of hedging relationships designated on a spot basis and for time value of options for hedging relationships designated on the basis of the intrinsic value. This is discussed further in Section B.

(c) *No hindsight:* this is the outcome of applying hedge accounting prospectively including the scenarios in which there are some practical concessions granted as transition reliefs.

Section A: Retrospective application

20. This section addresses requiring or permitting retrospective application of the new hedge accounting model, with or without an additional qualifying criterion of contemporaneous documentation (eg including running two models in parallel). It also includes discussion of specific situations raised by commentators that would cause hindsight because of the need for retrospective designation. These situations are risk components, aggregated exposures and groups and net positions. These are discussed further following the overall discussion of retrospective application.

Full retrospective application

21. IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* states that retrospective application results in the most useful information to users. IAS 8[5] also states that retrospective application is the preferred approach to transition unless it is

[5] IAS 8 paragraph 23-28

impracticable. If this is the case, the entity must adjust the comparative information to the earliest date practicable.

22. As noted in paragraphs 9-10 of the feedback summary, commentators asked for the possibility of retrospective application of the new hedge accounting model with two aims:

    (a) to be able to remove the inconsistencies between hedge accounting and risk management; and

    (b) to be able to present comparative figures (ie run two models in parallel).

23. The staff note that retrospective application, whether elective or required, and with or without a requirement for contemporaneous documentation (described further in paragraph 7(c)), creates the potential for entities to use hindsight in designation in order to retrospectively apply the new model. Because of the risk of hindsight, the staff consider that retrospective application requiring entities to go back and redesignate hedging relationships should not be considered further.

24. In addition to the risk of hindsight, the staff note the Board's historical position in previous amendments to hedge accounting requirements was not to allow retrospective application. The staff also note that this will create increased complexity and will require retrospective designation, which is inconsistent with the hedge accounting model. As a result, the staff recommend that the Board should not allow retrospective application of the new hedge accounting requirements if it would involve retrospective designation.

Question 1—Retrospective application

1. Does the Board agree with the staff recommendation in paragraph 24 that retrospective application should not be permitted if it requires retrospective designation of the hedging relationship? If not, what would the Board propose and why?

Question 2—Mandatory effective date
2. Does the Board agree to align the mandatory effective with the other phases of the project to replace IAS 39? If not, what would the Board propose and why?

Limited retrospective application

25. The following sections address specific issues raised by respondents requesting retrospective application—risk components, aggregated exposures and groups and net positions.

Risk components

26. As described in paragraphs 18, B13-B18 and BC52-BC60 of the ED, the proposals allow entities to designate risk components of both financial and non-financial items if they meet the criteria of the new model [6]. The staff consider that the new model will bring significant changes to risk components of non-financial items.

27. Commentators asking for the retrospective application of the new hedge accounting model to risk components want to adjust the hedging relationship with the aim of eliminating the designation mismatch that exists under IAS 39 because risk components were not available in this situation. Their request is also based on the fact that adjusting the hedging relationship at the transition date will not solve the issue in its entirety and will instead perpetuate some of the ineffectiveness that is due to discontinuing the hedging relationship at the transition date.

28. The staff note that in order to achieve the desired outcome (retrospective application), retrospective designation of the hedging relationship is needed. Similarly as for the general hedging requirements, in the staff's view this carries a significant risk of hindsight, which cannot be eliminated.

[6] See Agenda Papers 3-3C from the 28 July Board meeting for a discussion of risk components. At that meeting, the Board tentatively decided to confirm most of the risk components provisions in the ED, except to eliminate the restriction in the ED on hedging non-contractually-specified inflation risk but to add a 'caution' and 'rebuttable presumption' regarding non-contractually specified inflation risk components of financial items.

29. For this reason the staff do not recommend a one-off retrospective application for risk components. Instead, the staff recommend that entities should transition those hedging relationships prospectively in accordance with the discussion and recommendations in Section C of this paper.

Aggregated exposures

30. As described in paragraphs 15, B9 and BC48-BC51, the ED allows aggregated exposures that are a combination of a non-derivative and a derivative to be designated as a hedged item. (Synthetic accounting is, however, not permitted.). IAS 39 prohibits derivatives from being designated as a hedged item[7] with the exception of some purchased options that are hedged by a written option. Consequently, under IAS 39, in order to achieve the desired accounting outcome entities had to find alternative designations. For example, they would designate multiple derivatives as the hedging instrument in a hedging relationship with a hedged item that did not include a derivative instrument (because of the restrictions in the current model on designating derivatives as hedged items). These alternative designations have sometimes achieved the desired outcome—for example, when the combination of derivatives is designated at inception of the hedge and there has been no need for adjustments to the hedging relationship during its life. However, if entities later performed adjustments to the original hedge designation, the need for discontinuation and restarting of the whole combination of derivatives (the hedging instrument) created artificial ineffectiveness that was due to the non-zero fair value of some of the derivatives involved in the revised hedge.
31. Commentators who are asking for the possibility of retrospective designation of these hedges aim to eliminate this element of artificial ineffectiveness caused by the type of designation to which they were limited under IAS 39.
32. Similarly as for risk components above, the staff consider that retrospective designation should not be granted, because it carries a significant risk of hindsight and hence there is room for abuse. Instead, the staff recommend that entities should

[7] Refer to Agenda Paper 15 from the 20-22 July Board meeting for additional discussion of aggregated exposures.

transition those hedging relationships prospectively in accordance with the discussion and recommendations in Section C of this paper.

Groups and net positions

33. As described in paragraphs 12, 34, B70-76 and BC168-173, under the new model, groups may be designated as a hedged item if they consist of items that individually are eligible hedged items and are managed together on a group basis for risk management purposes (and fulfil the qualifying criteria for HA).[8]

34. Under IAS 39, groups can only be a hedged item if the individual items within the group share the same risk exposure that is designated as being hedged, and the change in fair value attributable to the hedged risk of each item in the group is approximately proportional to the change in fair value attributable to the hedged risk of the entire group[9]. In addition, net position hedges and fair value hedges of a layer component are not permitted. In the light of these restrictions, entities often designate individual hedged items or percentages of an entire item, or choose the gross positions that are expected to achieve a similar accounting outcome as if the hedge would have been designated on a net basis.

35. Commentators who are asking for the possibility of retrospective designation of these hedges for example want to use the designation of groups and net positions available under the new model to replace designations on a ‘gross’ basis that were accounting driven under IAS 39.

36. Similarly as for risk components and aggregated exposures above, the staff consider that retrospective designation should not be granted, because it carries a significant risk of hindsight and hence there is room for abuse. Instead, the staff recommend that entities should transition those hedging relationships prospectively in accordance with the discussion and recommendations in Section C in this paper.

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[8] See Agenda Papers 13 and 14 from the 20-22 July Board meeting for a discussion of groups and net positions.

[9] Refer to paragraph 83 of IAS 39.

Question 3:—Limited retrospective application
3. Does the Board agree with the staff recommendations in paragraphs 29, 32 and 36 that retrospective application should not be permitted for risk components, aggregated exposures and groups and net positions? If not, what would the Board propose and why?

Section B: Retrospective application without retrospective designation of a hedging relationship

37. This section addresses the request for requiring or permitting retrospective application of the new hedge accounting model to the time value of options, ie to a situation with the potential for hindsight only when applying particular accounting guidance—eg Level 3 valuations and amortisation of the aligned time value for time-period-related items.

Time value of options

38. For the time value of options under IAS 39, if the hedging instrument is designated only on an intrinsic value basis, the time value is recognised as a financial instrument at fair value through profit or loss. At the 2 June Board meeting[10] the Board tentatively decided to confirm the accounting for the time value of options in the ED; that is, that when the entity designates only the intrinsic value of an option as the hedging instrument, it must distinguish between hedged items that are transaction-related from those that are time-period-related and account for the time value as a cost of hedging. A summary of the requirements for accounting for time value of options is outlined in Appendix A

39. As described in paragraph 8 of this paper, some respondents asked the Board to allow retrospective application of the new requirements for time value of options with the aim of accurately reflecting the cost of hedging associated with the use of those option contracts.

40. The staff note that such a request is limited to the hedge designations that were previously made and that were made on an intrinsic value basis, where entities want to reflect the accurate cost of the one-sided protection.

[10] See Agenda Paper 7B from that meeting.

41. This request differs from the ones relating to risk components, aggregated exposures and groups and net positions because allowing retrospective application does *not* involve retrospective designation of the hedging relationship. Those hedging relationships were already designated on the basis of the option's intrinsic value under IAS 39. Instead, retrospective application would reclassify the cumulative change[11] of the time value of the option between line items within equity (retained earnings to OCI) at the transition date, which will subsequently allow the allocation to profit or loss of the cost of obtaining the one-sided protection.

42. The staff note that there is still some hindsight risk related to the level 3 valuation that is necessary in those cases in which the hedging relationship requires calculation of the aligned time value of the option. This involves some judgement and carries some potential for hindsight.

43. The staff note, however, that such hindsight is limited because of the hedge accounting that was applied concurrently under IAS 39 in the past. That means that the hedging relationship involving the option's intrinsic value had to pass the effectiveness assessment, which means that the option and the hedged item had to have a high degree of offset. Hence, the time value of the option relates to an option that is closely related to the hedged item (in terms of the underlying often being the same but at least closely correlated). This means that estimates for the key valuation input of volatility are subject to boundaries because they cannot be too different from the inputs used for calculating the fair value of the actual option, which had to be done concurrently under IAS 39 already. Any differences in the lives/maturities are straightforward and including those in the valuation is not subject to significant judgement. Hence, the staff consider that this is very different from a situation in which a Level 3 valuation would have to be performed for which no other similar concurrent valuation (like that for the actual option that is similar) ever existed.

44. The staff further consider that retrospective application in this case would significantly improve the usefulness of the information. Retrospective application

[11] For time period related hedged items reduced by the related cumulative amortisation.

would for example ensure that for a transaction related hedged item the costs of hedging reflecting the entities actual hedge are recognised. For example, if the accounting is changed some time during the life of an option (that extends over the date of transition) only the value changes after the date of transition would be deferred in OCI and included in the measurement of a resulting asset (or as an adjustment to hedged income or expenses). This means that it would not be the time value the entity actually paid being accounted for under the new model but only the cumulative value change in the time value from the date of transition. Depending on the movements in the option's time value up to the date of transition, this could be more or less than the time value the entity actually paid. The staff consider that this outcome is clearly inferior to retrospective application.

45. In addition the accounting treatment for time value of options is mandatory under the new hedge accounting model, and hence it would seem inconsistent that the cost of hedging cannot be reported accurately.

46. Consequently, on the basis of the arguments above, the staff are of the view that for hedge designations on an intrinsic value basis, retrospective application at the date of initial application should be *required* to calculate the amount of the time value that represents the cost of hedging using the option designated within the hedging relationship for those hedging relationships that exist during the comparative period. Mandating retrospective application (rather than making it optional) is most appropriate to increase comparability and because this accounting for time value of options is mandatory.

Question 4:—Retrospective application to the time value of options
4. Does the Board agree with the staff recommendation in paragraph 46 that retrospective application should be required for the time value of options whose intrinsic value has previously been designated as a hedging instrument? If not, what would the Board propose and why?

Forward points

47. For forward points under IAS 39, if the hedging instrument is designated only as the spot element of a forward contract, the forward element is recognised as a financial instrument at fair value through profit or loss[12].

48. At the 20 July Board meeting[13], the Board tentatively decided to permit, but not require the forward element that exists at inception of the hedging relationship to be recognised (ie amortised) in profit or loss over time on a rational basis and to accumulate subsequent fair value changes in accumulated other comprehensive income. This has been granted with the aim of providing a better representation of the economic substance of transactions, for example in the case of a funding swap transaction and the consequences for the net interest margin.

49. This request related to retrospective application of the alternative treatment for forward elements is similar to the one for time value of options and differs from the ones relating to risk components, aggregated exposures and groups and net positions. Allowing retrospective application for forward elements does not involve retrospective designation of the hedging relationship, which the staff do not believe should be allowed (see paragraph 24 in this paper), but involves instead reclassifying amounts from retained earnings to OCI —that is, the forward element of a forward contract when it is excluded from the hedging instrument if the alternative treatment is elected.

50. Though there is no need for retrospective designation, there would nonetheless be potential for hindsight if entities could elect the alternative treatment on a

[12] Using the forward rate method in IAS 39 leads to an equivalent accounting outcome as for the tentatively confirmed decision on the time value of options for transaction-related hedged items—that is, the forward element is deferred and accounted for on the basis of the hedged item.

[13] See Agenda Paper 12 from that meeting.

hedge-by-hedge basis. However, the staff note that this risk can be mitigated by making the alternative treatment available retrospectively on an 'all-or-nothing' basis for qualifying relationships (ie an entity needs to make that election for all relevant hedging relationships on transition—or none of them).

51. The staff also note that there is a remaining risk of hindsight in applying other accounting guidance to the hedging relationships with forward elements—eg in applying Level 3 valuations to arrive at the aligned forward points and consequently to the amortisation amount. However, the staff note that the risk of hindsight is limited because of the hedge accounting that was applied concurrently under IAS 39 in the past. The staff consider that the same rationale explained regarding the time value of options applies (see paragraph 43). The staff consider that for forward type contracts the valuation inputs require even less judgement than for options (as volatility as an input does not apply).

52. Also, similar to the considerations regarding the time value of options, the staff consider that retrospective application in this case would significantly improve the usefulness of the information. Retrospective application would for example improve the comparability of the net interest margin whereas without retrospective application the net interest margin would be distorted for the comparative period.

53. Consequently, the staff recommend that retrospective application of the alternative treatment for forward elements should be available at the date of initial application on an all-or-nothing basis for hedges that exist during the comparative period. Retrospective application is permitted but not required for forward points because unlike the treatment for time value of options because the treatment itself is optional.

Question 5: Retrospective application to forward points
5. Does the Board agree with the staff recommendation in paragraph 52 that retrospective application should be permitted for the alternative treatment of forward elements on an all-or-nothing basis for qualifying relationships? 6. If so, does the Board agree that this should be permitted? 7. If not, what would the Board propose and why?

Section C: Practical considerations

54. This section addresses the practical considerations that entities may take into account in the context of prospective application. These are the scenarios in which retrospective application is not applicable, as referred to in the discussion and staff recommendations in Sections A and B.As noted in paragraph 7(a) in the feedback summary, some respondents requested a one-off opportunity to discontinue and restart hedging relationships that no longer qualify under the new model on a broader basis either at the date of initial application on a relationship-by-relationship basis. A few also asked for a broader approach whereby voluntary discontinuation and restart would be allowed on an ongoing basis. Paragraphs 24, B61-66 of the ED and BC112-118 of the Basis for Conclusions to the Exposure Draft discuss discontinuation under the new model, which is permitted only when the hedging relationship (or part of the hedging relationship) ceases to meet the qualifying criteria (after taking into accounting any rebalancing of the hedging relationship, if applicable). The Board's basis for this conclusion was that voluntary discontinuation of hedge accounting when the entity's risk management objective has not changed does not result in useful information. However, under IAS 39, discontinuation was permitted at any time for no reason.

55. The staff do not consider that a one-off transition provision to allow entities to voluntarily discontinue and restart hedging relationships should be included in the new guidance, because entities will be able to do this under IAS 39 before applying the new model (ie on the last date of applying IAS 39), which would result in a 'clean slate' for the new model. Hence, such a one-off transition provision is not needed.

56. As a clarification, the staff consider that for transition purposes entities can consider the 'same logical second' when transitioning to the new model. This addresses the time lag between starting the use of the new model and stopping the use of the old model, which involves the potential for significant changes in market values between those two times that would cause difficulty in applying hedge accounting under the new model for hedging relationships that would otherwise qualify. As a result, entities would be able to remove the hedge designation immediately before the transition to the new model and start new hedging relationships under the new model. Consequently, the staff recommend that a clarification should be added to allow the date of initial application to be immediately following the moment where an entity stops applying IAS 39 (ie ceasing to apply IAS 39 and applying the new requirements at exactly the 'same logical second').

Question 6:—Prospective application and practical accommodations

8. Does the Board agree with the staff recommendation in paragraph 56 that a clarification should be added to allow entities to apply the new hedge accounting model immediately after ceasing to apply the IAS 39 model? If not, what would the Board propose and why?

Section D: Requests for additional guidance

Rebalancing

57. Commentators requested more guidance on how to apply the proposed rebalancing and discontinuation provisions at transition. They have also requested additional guidance on the meaning of a 'continuing hedge' because, in their view, it is not clear what it means for hedges that are treated differently in the two models.

58. The staff note that the request for guidance on how to apply the notion of rebalancing relates to the difference in the way the hedge ratio is determined under the current and under the new model.

59. The current model gives entities the option to choose a hedge ratio other than one-to-one as long as the expected hedge effectiveness assessment is still met (unless it would abuse the 'lower of' test for a cash flow hedge[14]).

60. As part of the redeliberations the Board tentatively decided that the hedge ratio for hedge accounting purposes shall be the one actually used for the economic hedge, unless the hedge ratio is designed in such way that it creates an accounting outcome that is inconsistent with the objective of hedge accounting[15].

61. The staff also note that the two models have different objectives when setting the hedge ratio. While the current model provides it as a means to help meet the percentage-based bright line, the new model is based on the hedge ratio used for commercial/risk management purposes. These might be different at transition and therefore generate the need for rebalancing the hedge ratio of hedging relationships that meet all the qualifying criteria, including the risk management objective, but that fail to meet the requirements regarding the hedge ratio.

62. The staff note that this neither involves any form of retrospective designation, nor has it a risk of hindsight and it is limited to adjustments to a continuing hedging relationship for the purpose of maintaining a hedge ratio that complies with the hedge effectiveness requirements.

63. Consequently, the staff recommend that a transition provision should be granted whereby entities will be required to consider, for the purpose of rebalancing, the ratio used under IAS 39 as the starting point for rebalancing as of the transition date. This will ensure that the hedge ratio reflects what is being done for risk management purposes as of the transition date.

64. In practice this transition provision can be operationalised as follows:

    (a) all the ineffectiveness is recognised in retained earnings at the transition date;

    (b) the hedging relationship is rebalanced and accounted for as a continuing hedge; and

[14] Refer to paragraph AG107A.

[15] Refer to Agenda papers series 1 presented at the May 2011 Board Meeting

(c) any gain or loss arising from the rebalancing of these hedging relationships is recognised in profit or loss.

65. This would avoid that in such cases an entity has to discontinue and restart the hedging relationship because the hedge ratio cannot be changed without discontinuing the hedging relationship under IAS 39 but without that adjustment that hedging relationship would not qualify under IFRS 9. In other words, it would 'fall through the cracks' for what usually would be a small change.

Question 7:—Rebalancing

9. Does the Board agree with the staff recommendation in paragraphs 63 and 64? If not, what would the Board propose and why?

Appendix A

A1. The change in time value of an option that hedges a transaction-related hedged item is recognised in other comprehensive income to the extent that it relates to the hedged item. The cumulative change in fair value arising from the time value of the option that has been accumulated is accounted for on the basis of the hedged item as follows:

(a) For hedged items that subsequently result in the recognition of a non-financial asset or liability, or a firm commitment to which fair value hedge accounting is applied, the amount is removed and adjusts the initial carrying amount of the hedged item (ie it does not affect profit or loss).

(b) For other hedging relationships, the amount is removed and affects profit or loss in the same period as the hedged item.

A2. The change in time value of an option that hedges a time-period-related hedged item is recognised in other comprehensive income to the extent that is relates to the hedged item. The original time value paid to the option writer or seller, to the extent that it relates to the hedged item, is amortised on a rational basis over the term of the hedging relationship as a reclassification adjustment.